CENTRE FOR THE FUTURE STATE

***How can public action lead to productive private investment and economic growth in poor countries? What explains the variation in outcomes in different sectors and regions?***

It is widely accepted that increased private investment is necessary for the economic growth required for substantial poverty reduction to occur. Recommendations for improving the investment climate in poor countries typically stress the need for appropriate formal rules and institutions that conform with best practice derived from OECD countries. Rules-based governance is a good long-term goal, but is often not feasible for poor countries in the short to medium-term. Policymakers should instead take into account a country's stage of economic development and the particular constraints it faces.

In the short to medium-term, relationships between policymakers and investors, including informal relationships, may be an important factor in overcoming barriers to investment. The idea of policymakers and investors working closely together has often been treated with suspicion and viewed as synonymous with corruption and cronyism. However, evidence indicates that under some conditions such relationships can be an important way of improving the investment climate. Policymakers should therefore be more open-minded. Informal transitional arrangements deserve greater attention as potentially effective transitional arrangements to enhance economic growth.

## *Informal relationships and investment*

Formal rules and institutions, such as legal protection of property rights, legal enforceability of contracts and clear tax regulations, are expected to encourage investment by reducing associated risks. However, in some contexts, relationships between government and business can compensate for weak formal governance arrangements by increasing trust and removing other obstacles to investment. The importance of relationships helps to explain variation in investment between sectors and good performance in some areas in countries that are otherwise thought to have poor investment climates.

## *Common interest and informal relationships*

There are three key features of effective business-government alliances for growth:

1. Common interest in the sector's growth
2. Common understanding of its problems
3. The involvement of actors with the ability to take action

Informal relationships can be productive when policymakers and investors perceive themselves to have common interests and a shared understanding of the challenges they face. Whilst investors can maximise profit through the removal of obstacles and policy that benefits a particular sector, policymakers can hope for personal gain in reputation or political influence through their role in boosting economic growth and job creation. This is particularly likely when investment in a sector generates tangible results for which policymakers can take credit, for example jobs or exports.

The willingness to act generated by perceived shared interests will only be translated into increased investment if the actors involved are able to influence policy. In the case of Egypt, where Centre for the Future State research was conducted, successful growth alliances extended to the upper echelons of government. Outcomes are also conditioned by the private sector and its organisational capacity. Although policy failures are often attributed to public sector shortcomings, the weaknesses of the private sector should receive equal attention.

***Particularistic or universal gains?***

Effective growth alliances require more than just committed individuals. Both sides of the public-private alliance need organisational capacity. How the private sector is organised affects both whether it is possible to form relationships between public sector institutions and business and the outcomes of any joint action. Private sector organisation that is broad-based is more likely than exclusive arrangements to lead to sector-wide gains and avoid the potentially negative effects of government-business relations.

Other contextual factors such as competitive pressure in a particular sector, monitoring of sectoral performance, a free and engaged media and the existence of consumer protection legislation and agencies may also prevent relationships being abused, although they are unlikely to be present in many developing countries.

***Policy implications***

Although the potential for external actors to influence the processes through which informal relationships affect the investment climate and growth may be limited, policymakers should still reconsider their starting assumptions. Instead of focusing on how perceived deficiencies in rules-based governance might be remedied they should ask what is actually driving the interests of political and business leaders, whether there is scope for productive bargaining between them, and how far this might overlap with a progressive agenda. Attempts could be made to shift incentives towards productive dialogue between public and private actors.

Further research in this area will be very instructive. Questions which should be addressed concern the extent to which informal relationships can be institutionalised, for example in the form of Competitiveness Councils, and whether growth alliances based on common interest can be constructed from the outside.

***Growth alliances in Egypt***

Comparative research in Egypt demonstrated the importance of informal relationships between government policymakers and potential investors in stimulating investment and growth in the short to medium term. Two well established sectors (food and furniture) and two newer sectors (information technology and communications) were studied to probe the extent to which their differential performance was affected by informal relationships between government and business representatives.

Egypt has generally been perceived as having a poor investment climate. Despite significant legal reforms declining levels of investment and growth have been recorded over most of the last three decades. However, since 2004 there has been significant improvement in overall levels of private investment.

The improvement coincided with a change in government and the appointment of business representatives to ministerial posts as well as a number of important regulatory changes. However, formal legal factors cannot fully explain the increase in investment as such changes had very little impact in the preceding 30 years and there was significant variation between sectors. Changes in the regulatory structure do not explain why constraints that were not dealt with, such as slow judicial processes were overcome, or why investment began to increase before 2004 in some sectors.

*Informal relationships based on common interest*

Informal relationships between investors and government officials were influential when based upon a perceived common interest and shared understanding of the problems faced.

They provided sector-specific proxy governance benefits that reduced risk for investors and increased likelihood of profit. Examples of proxy governance that assisted the growth of the IT industry included allowing investors informal early access to tenders before they were officially announced and policy changes benefitting the sector, including reduced taxes on IT equipment.

Informal relationships also facilitated politically sensitive decision-making. For example, the government was able to announce an end to an economically unviable energy subsidy with hardly any resistance having engaged in informal talks with industrialists behind closed doors before the announcement.

*Ability to act upon common interest*

The importance of the ability of actors to translate their common interests into productive action emerged from all sectors studied in Egypt. In all cases the close alliance between high level policymakers and big investors extended into the cabinet, and in the case of the communications and IT industries to the level of the President.

*Extending benefits across sectors*

Contextual factors related to both the public and private sector were important in preventing the negative 'crony' effects often assumed to result from informal relationships.

Although the relationships observed initially offered only narrow benefits, where the private sector had effective and legitimate leadership and broad-based organisation the gains were more inclusive. This is illustrated by the relatively narrow benefits attained by businesses in the furniture industry, where the Furniture Chamber comprises less than ten per cent of producers, in contrast to those seen in the food sector, where the Food Chamber has almost one hundred per cent membership of formal businesses in the sector.

The political and economic context meant that high-level policymakers had incentives to deliver on a range of public goods and were subject to media scrutiny.

**Further reading:**

Abdel-Latif, Abla and Schmitz, Hubert (2009) *State-Business Relations and Investment in Egypt*, IDS Research Report 61, Brighton: IDS

Moore, Mick and Schmitz, Hubert (2008) *Idealism, Realism and the Investment Climate in Developing Countries*, IDS Working Paper 307, Brighton: IDS